

REGULATORY OVERHAUL OF THE OTC DERIVATIVES MARKET: THE COSTS, RISKS AND POLITICS

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I. INTRODUCTION

In the wake of the worst financial crisis since the Great Depression, policymakers and the general public are attempting to determine how such a complete system-wide failure occurred. While there is neither a single nor simple answer to this question, much blame has been directed at the over-the-counter (“OTC”) derivative market. Brooksley Borne, the former chairwoman of the Commodity Future Trading Commission (“CFTC”) stated that “the toxic assets of many of our biggest banks are over-the-counter derivatives and [they] caused the economic downturn that made us lose our savings, lose our jobs, lose our homes,”¹ while Warren Buffet called derivatives “financial weapons of mass destruction.”² In response to the widespread belief that derivatives were at the root of the recent financial crisis, the Obama administration and Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). Title VII of this Act, titled “Wall Street Transparency and Accountability,” places a number of new restrictions on the OTC derivatives market. This paper will focus on the characteristics of the OTC market, effects of the statute, and suggestions for improved regulation.

A. *What is a Derivative?*

A derivative is a financial contract that derives its value from market conditions in the contract’s “underlying,” which can be, inter alia, asset prices or index levels.³ The derivatives market, despite its size and complexity, is composed primarily of only forwards, futures, options, and

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¹ *Frontline: The Warning* (PBS television broadcast Oct. 20, 2009), <http://www.pbs.org/wgbh/pages/frontline/warning/etc/script.html>.

² *Buffett Warns on Investment ‘Time Bomb’*, BBC NEWS, Mar. 4, 2003, <http://news.bbc.co.uk/2/hi/2817995.stm>.

³ Henry T.C. Hu, *Misunderstood Derivatives: The Cause of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1464–65 (1993).

swaps.⁴ Forwards and futures are contracts that obligate a buyer to buy and a seller to sell a certain amount of something to one another at a set maturity date for a predetermined price.⁵ Though there are several characteristics that distinguish forwards from futures, the primary difference is that the former is traded in the OTC market while the latter is traded on organized exchanges.⁶ Options are similar to forwards and futures in most characteristics except that forwards and futures obligate both parties to perform the terms of the contract while in an option, only the seller is obligated to perform at the option of the buyer in exchange for a fee charged to the buyer.⁷ In contrast to other types of derivatives, swaps are agreements that obligate the counterparties to exchange payments over a period of time that reflect changes in the market for the swap's underlying.⁸

Special note should be made of the credit default swap ("CDS"), which is an instrument that was not only at the center of the recent financial crisis, but also contains a number of features that distinguish it from traditional swaps. In a typical CDS, the buyer will pay a fee to the seller who agrees to pay the buyer a specified amount in the event that "credit events" take place on an underlying debt instrument.⁹ A CDS is unlike other swaps because it is not a periodic swap of cash flows, but, rather, one party paying another for insurance against certain credit events that can include, *inter alia*, the failure of the borrower of the underlying debt instrument to pay back their debt in accordance with the loan agreement (i.e., the borrower defaults).¹⁰

⁴ Robert J. Aalberts & Percy S. Poon, *Derivatives and the Modern Prudent Investor Rule: Too Risky or Too Necessary?*, 67 OHIO ST. L.J. 525, 546 (2006).

⁵ *Id.* at 546–49.

⁶ *Id.* at 547–48.

⁷ There are two types of options: call options and put options. *Id.* at 549–550. A call option grants the buyer the right to purchase the underlying asset at a given price (i.e., strike price) by a given date (i.e., expiration date), while a put option grants the buyer the right to sell. *Id.*

⁸ A simple example of a swap is a fixed for floating interest rate swap. In this type of swap, one counterparty will exchange a payment based on a fixed interest rate on a specified amount of money (i.e., notional amount) in return for a payment based on an interest rate that varies with a given market rate (e.g., LIBOR) on a given notional amount. *Id.* at 550.

⁹ Bruce E. Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, 851 PLI/TAX 123, 129 (2008).

¹⁰ *Id.*

B. What is the Basic Structure of the Derivatives Market?

The whole of the global derivatives market can be separated into the exchange traded market and OTC market.¹¹ The primary difference between the two markets is the way in which the contracts are traded. In the exchange traded market, buyers and sellers typically place orders with their brokers who then go to a formal, organized exchange (e.g., the Chicago Mercantile Exchange) that acts as a “central marketplace where all orders are collected and matched.”¹² Prior to Dodd-Frank, the only types of derivatives traded on exchanges were futures and options.¹³ In contrast to exchange traded derivatives, OTC derivatives were, prior to Dodd-Frank, traded bilaterally rather than through an exchange.¹⁴ A customer wishing to enter an OTC derivative would go to his broker-dealer, who would either enter into the contract directly with its customer or arrange a contract with another broker-dealer.¹⁵ In past years, the vast majority of trades took place in the OTC market.¹⁶

C. How are Derivatives Used?

Derivatives are primarily used either for risk management or speculation.¹⁷ As a risk management tool, derivatives allow a business to hedge against future market risks.¹⁸ An example of hedging is the use by financial institutions of fixed for floating interest rate swaps to guard against interest rate risk.¹⁹ Interest rate risk is a problem for a number of financial institutions because the rates they pay on their liabilities fluctuate often while the rates banks earn on their assets are stable.²⁰ This disparity

¹¹ Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 731 (2002).

¹² Deutsche Börse AG, *The Global Derivatives Market: An Overview*, DEUTSCHE BORSE GROUP 17 (2008), http://www.eurexchange.com/download/documents/publications/global_derivatives_market.pdf.

¹³ Bank for Int’l Settlements, *Table 23A: Derivative financial instruments traded on organised exchanges*, BIS QUARTERLY REVIEW A126 (2010), http://www.bis.org/publ/qtrpdf/r_qa1006.pdf#page=126.

¹⁴ Deutsche Börse AG, *supra* note 12, at 6, 17.

¹⁵ *Id.* at 17.

¹⁶ *Id.* at 4 (“Only around 16% of the notional amount outstanding is traded on exchanges.”).

¹⁷ See Feder, *supra* note 11, at 717.

¹⁸ In its simplest terms, a hedging strategy is where an entity enters a derivative with a value that is inversely correlated to a position already on its books, so as the value of one position decreases, the other increases, thereby offsetting any losses. *Id.*

¹⁹ Daniel P. Cunningham, William P. Rodgers, Jr. & George W. Bilicic, Jr., *Interest Rate and Currency Swaps and Related Transactions*, 778 PLI/CORP 9, 15 (1992).

²⁰ *Id.*

in rates can lead to significant losses if market rates suddenly jump and was one of the primary causes of the savings and loan crisis in the 1980s.²¹ An interest rate swap allows banks to swap the fixed rate they receive on their assets for variable rate interest payments with the result that the movement in the rate of return on their assets keeps pace with the interest payments they must make on their liabilities. Derivatives are extremely popular as risk management tools, and a report approximates that ninety-four percent of the 500 largest companies use some form of derivative for risk management purposes.²²

While hedging strategies are used to reduce an entity's risk exposure, if an entity is taking a speculative position, it is taking on risk by betting on future market conditions.²³ Using derivatives to speculate was the root cause of most of the headlining derivatives related losses, including the bankruptcy of Orange County, the failure of Long Term Capital Management ("LTCM"), the fatal losses at Barings Bank, and the near collapse of American International Group ("AIG").²⁴ Unfortunately, evidence suggests that derivatives are more commonly used for speculative rather than hedging purposes.²⁵

D. *What risks do derivatives pose?*

1. *Market Risk*

Market risk is the risk that a firm will sustain losses as adverse price movements in the derivative's underlying will cause it to lose value.²⁶ The level of market risk posed by a firm's derivative position is determined by a number of variables and can be a significant risk to that firm. However, the market risk posed to the economy as a whole by the derivatives market is

²¹ Luke Zubrod, *Beware of the Mongoose*, FIN. TIMES, June 17, 2010, <http://www.ft.com/cms/s/0/99e016e6-7a1e-11df-9871-00144feabdc0.html>.

²² Press Release, International Swaps and Derivatives Association, Over 94% of the World's Largest Companies Use Derivatives to Help Manage Their Risks, According to ISDA Survey (Apr. 23, 2009), *available at* <http://www.isda.org/press/press042309der.pdf>.

²³ In a speculative trade, the entity has no offsetting position, so it bears all the gains and losses of any movements in the derivative's value.

²⁴ Lynn A. Stout, *Regulate OTC Derivatives by Deregulating Them*, CATO INSTITUTE 30, 32 (2009), <http://www.cato.org/pubs/regulation/regv32n3/v32n3-1.pdf>.

²⁵ *Id.* at 33.

²⁶ OFFICE OF THE COMPTROLLER OF THE CURRENCY, RISK MGMT. OF FINANCIAL DERIVATIVES: COMPTROLLER'S HANDBOOK 18 (1997), *available at* <http://www.occ.treas.gov/handbook/deriv.pdf> [hereinafter OCC].

always going to be zero.²⁷ This is because, for every dollar lost on a derivatives trade, the loser's counterparty will gain a dollar (i.e., it is a zero sum game); therefore, there will never be a net loss as the result of market risk.²⁸

The primary determinant of the price of a derivative is the market conditions of the underlying, and, as a result, the extent of market risk of a swap is largely determined by the risk inherent in the underlying's market.²⁹ For example, if a firm is writing CDSs on junk bonds, the firm will be exposed to a higher level of market risk than if the firm were offering CDSs on bonds from entities with high credit ratings. While the market risk of the underlying is an important determinant of risk levels, this risk can be either mitigated or exacerbated by the final two components of market risk: the price sensitivity of the derivative and the liquidity of the derivatives market.³⁰

Price sensitivity is the extent to which the value of the derivative will change in response to a change in the market for the underlying and is determined by a number of factors, including, *inter alia*, the terms of the contract, maturity, and amount of leverage.³¹ Among all the factors affecting price sensitivity, large amounts of leverage have been perceived as raising market risks to unacceptable levels.³² Leverage, a characteristic inherent in all derivatives, is a means by which investors reduce the initial cost of their investments and increase their size by putting up only a small amount of cash for large positions in the market.³³

The second determinant of market risk is the liquidity of the instrument, which is defined as the ability to buy or sell the asset quickly without having a significant effect on its price.³⁴ In an illiquid market, a firm may have to sell at a deep discount in order to rid itself of the position quickly. The liquidity of the derivatives market affects the market risk associated

²⁷ Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 15 (1997).

²⁸ *Id.*

²⁹ OCC, *supra* note 26, at 18.

³⁰ *Id.*

³¹ *Id.*

³² E.g., Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 254 (2009) ("A highly leveraged financial system is like a powder keg—it can turn a small spark, relatively harmless in most environments, into a large and devastating explosion.").

³³ OCC, *supra* note 26, at 21 ("By definition, derivative contracts are leveraged because for a relatively small performance bond (e.g., margin) or premium, a counterparty can enter into a transaction that possesses the risk/return tradeoff of a much larger dollar volume of the underlying cash instrument.").

³⁴ Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 AM. U. L. REV. 1023, 1043–44 (1994).

with a derivative because, if the market is illiquid, this will either prolong the time it takes to unwind a losing position, thereby exposing the firm to increased losses, or it will increase the cost of quickly unwinding the position.³⁵

It is important to remember that the market risk associated with individual contracts is not of particular importance because a firm will often have offsetting positions that will counteract losses or gains in one instrument; therefore, it is important to look at a firm's entire balance sheet when calculating its market risk.³⁶ Generally speaking, the market risk can be reduced or eliminated by hedging the position, so that, as one instrument loses value, the other will offset the losses, but there is another form of market risk associated with some of these positions called correlation or basis risk.³⁷

For a hedge to work properly, the value of the position being hedged must have an inverse relationship to that of the derivative, so, as the value of the hedged position decreases, those losses are offset by the increase in value of the derivative and vice versa. Basis risk "is the risk that correlation between two prices may change," which, in turn, may increase a firm's net market risk.³⁸ Basis risk can result either from inefficiencies in the derivatives market that cause the value of a derivatives and its underlying to be imperfectly correlated or from a change in the historical correlation between the hedged and hedging positions.³⁹

2. Counterparty risk

Counterparty risk is the risk associated with the failure of a firm's counterparty to perform its obligations under a derivatives agreement, which would cause the firm to sustain a loss.⁴⁰ Because counterparty risk can be quite significant, firms should carefully evaluate the creditworthiness of their counterparties and reevaluate these assessments as market conditions change. Counterparty risk is composed of both current and potential credit exposures.⁴¹

The current risk exposure on any given derivative is equal to the price the non-defaulting counterparty would have to pay in the market to replace the defaulted upon derivative with an identical derivative from another

³⁵ *Id.*

³⁶ Barry W. Taylor, *Derivatives Product Activities of Commercial Banks*, 815 PLI/CORP 209, 226-27 (1993).

³⁷ See OCC, *supra* note 26, at 18-20.

³⁸ OCC, *supra* note 26, at 20.

³⁹ *Id.*; Krawiec, *supra* note 27, at 20.

⁴⁰ Taylor, *supra* note 36, at 222.

⁴¹ *Derivatives Risk in Commercial Banking*, FED. DEPOSIT INS. CORP. (Mar. 26, 2003), <http://www.fdic.gov/bank/analytical/fyi/2003/032603fyi.html>.

counterparty.⁴² For example, assume a swap is entered into with a value of zero, meaning that the market views the cash flows being swapped are equal. Though the initial value of the swap is zero, as market conditions move against one counterparty and for the benefit of the other, the fair market value of the swap will be positive for the counterparty that benefitted and negative for the other.⁴³ The positive fair value reflects the fact that the terms of the swap are more favorable than the prevailing market conditions and represents the premium that would have to be paid in order to enter into a new swap with identical terms.⁴⁴ While the holder of the positively valued derivative has a current credit exposure equal to the replacement cost, the holder of the negatively valued derivative has no exposure because it is a losing contract and, therefore, would not be harmed if its counterparty defaulted.⁴⁵ The negative fair value essentially reflects how much less the party is making under the swap agreement than the party could make if they were to use current market rates.⁴⁶

Firms also face potential exposure because the positive and negative fair values are not static.⁴⁷ Although it can be difficult and possibly inaccurate, by taking certain variables into consideration, a reasonable estimate of potential future credit exposure can be made.⁴⁸ Variables that are taken into account include the swap maturity length (the potential for exposure increases with the length of maturity) and the volatility of the underlying.⁴⁹

Evaluating the credit risk of individual derivatives does not fully indicate the credit exposure of a given counterparty because of the existence of bilateral netting agreements. When entering into an OTC derivative, parties will typically use a standard form called the International Swaps and Derivatives Association (“ISDA”) Master Agreement that has a bilateral netting provision that allows the parties to document all the derivatives transactions in which they both participate and aggregate their obligations.⁵⁰ Because of bilateral netting, the real credit exposure posed by

⁴² *Id.*

⁴³ Barry W. Taylor, *Running with the Pack: The Collective Behavior of Swap Dealers*, 603 PLI/CORP 45, 66 (1988).

⁴⁴ *Id.*

⁴⁵ *See id.*

⁴⁶ *See id.*

⁴⁷ Taylor, *supra* note 36, at 224.

⁴⁸ *Id.*

⁴⁹ *See id.*

⁵⁰ *Credit Default Swaps and Counterparty Risk*, EUR. CEN. BANK, 42–43 (2009), <http://www.ecb.int/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf>

a given counterparty is the net of the positive and negative fair value of all the derivatives in which a firm has entered with that counterparty.⁵¹

3. Operational Risk

Operational risk is “the risk that deficiencies in information systems or internal controls, human error, or risk management failure result in unexpected losses.”⁵² Operational risk has two different components. The first component is the risk of loss that can arise from day-to-day errors that pose limited risk to the institution, such as data entry errors or similar clerical mistakes.⁵³ The second component is the risk that arises from events that are uncommon but that can result in large losses due to factors such as natural disasters or fraud.⁵⁴

One source of operational risk that is particularly worrisome for those holding derivatives is fraud. The significance of this risk is emphasized by an Federal Deposit Insurance Corporation (“FDIC”) report which found that many of the largest derivatives related losses at banks were the result of failures of risk managers to identify and stop the fraudulent activity of employees.⁵⁵ Derivatives are particularly pernicious in creating this type of risk because of their complexity.⁵⁶ While some derivatives are relatively simple to understand many are so complex that “[t]he complexity can overwhelm even experts.”⁵⁷ Complexity is primarily a problem in the OTC market where the parties are free to draft the contracts to be extremely complex, as opposed to the exchange market where contracts are standardized.⁵⁸ Unfortunately, although the individualized contracts in the OTC market are beneficial in that they allow parties to draft agreements

⁵¹ For example, if a firm’s derivatives with a given counterparty have a positive fair value of \$100 but the firm also has derivatives with this same counterparty with a negative fair value of ninety-nine dollars, then the net current credit exposure is only one dollar. The firm will have to pay \$100 to enter replacement contracts that would be offset by ninety-nine dollars, which the firm will not have to pay on its obligation on the losing swaps. *See id.*

⁵² Deutsche Börse AG, *supra* note 12, at 38.

⁵³ Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 134–35 (2009).

⁵⁴ *Id.* at 135.

⁵⁵ *Derivatives Risk in Commercial Banking*, *supra* note 41.

⁵⁶ Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risk*, 2002 U. ILL. L. REV. 215, 350 (2002).

⁵⁷ Hu, *supra* note 3, at 1480.

⁵⁸ Deutsche Börse AG, *supra* note 12, at 10.

that fit their needs perfectly, as the terms of the swap become more esoteric, parties may be able to fraudulently conceal the true risk of the transaction.⁵⁹

4. Systemic Risk

Systemic risk is the risk that financial problems in one institution or market will spread to other institutions and markets with the result that the losses from a seemingly isolated market event might threaten the entire economy.⁶⁰ The near collapse and subsequent government organized bailout of LTCM is a prime example of the way in which derivatives cause systemic risk. LTCM was a prominent player in the derivatives market with approximately \$500 billion in outstanding exchange-traded derivatives and “at least” \$750 billion in the OTC market and was one of the most active participants in interest rate swaps.⁶¹ As a result of these positions, LTCM was “counterparty to over 20,000 transactions and conducted business with over 75 counterparties.”⁶² In the derivatives market, systemic risk is brought about in two different ways, both of which were present during the collapse of LTCM. First, because many of LTCM’s derivatives were not cleared, its counterparties were directly exposed to the risk that it would collapse—i.e., counterparty risk.⁶³ Analysts estimate that LTCM’s counterparties lost between \$3 billion to \$5 billion.⁶⁴ Regulators were not particularly concerned about the losses because the counterparties were sufficiently capitalized to absorb the losses.⁶⁵ Though counterparty losses were not a significant concern during the LTCM collapse, when AIG was on the brink of collapse, there were concerns that if AIG were to default on its CDSs, its counterparties would go bankrupt and, as a result, the entire financial system could collapse.⁶⁶

Second, the collapse of LTCM would have posed systemic risk because if LTCM defaulted on its derivatives positions, its counterparties would be forced to rebalance their risk exposure.⁶⁷ As the derivatives became worthless, these firms would have been exposed to whatever risk the derivatives had been hedging. In order to eliminate the risk exposure, the counterparties could either contract for similar derivatives with other counterparties or liquidate the positions that LTCM derivatives had been

⁵⁹ See, e.g., *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1274 (S.D. Ohio 1996).

⁶⁰ Feder, *supra* note 11, at 729.

⁶¹ U.S. GOV’T. ACCOUNTABILITY OFFICE, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK 7 (1999), available at <http://www.gao.gov/archive/2000/gg00003.pdf> [hereinafter GAO].

⁶² *Id.*

⁶³ Deutsche Börse AG, *supra* note 12, at 17.

⁶⁴ GAO, *supra* note 61, at 12.

⁶⁵ *Id.*

⁶⁶ See Stout, *supra* note 24, at 30.

⁶⁷ GAO, *supra* note 61, at 13.

hedging.⁶⁸ Given the size of LTCM's positions, the rush to purchase other derivatives and/or liquidate assets would have resulted in extremely volatile prices that could have caused significant losses and put extreme pressure on markets that were already strained by the Russian financial crisis.⁶⁹ As a result, the New York Federal Reserve Bank organized a private sector bailout of LTCM in which a number of large banks that dealt with LTCM agreed to contribute about \$4 billion, which allowed LTCM to liquidate in an orderly fashion without major impact on the markets.⁷⁰

II. PAST REGULATION OF OVER-THE-COUNTER DERIVATIVES

The regulatory structure surrounding derivatives is extremely complex and involves the Securities and Exchange Commission ("SEC"), the CFTC, and a plethora of self-regulatory bodies. Although exchange traded derivatives have been subject to extensive regulation for some time, OTC derivatives have largely operated in an unregulated market. The lack of regulation prior to the enactment of Dodd-Frank was the result of the Commodities Futures Modernization Act ("CFMA"), which became law in 2000. The CFMA was largely enacted in response to an attempt by the CFTC to regulate OTC derivatives.⁷¹

In the late 1990s, Brooksley Born, a lawyer appointed by President Bill Clinton to head the CFTC, spearheaded an attempt to regulate the OTC derivatives market, particularly swaps and hybrid instruments.⁷² On May 7, 1998, the CFTC took the first step towards regulating the OTC derivatives market by issuing a concept release.⁷³ The release indicated that the CFTC was considering a number of possible regulatory changes in response to the dramatic increase in the size of the OTC derivative market, the increased

⁶⁸ *Id.*

⁶⁹ *Risk of Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Financial Servs.*, 105th Cong. (1998) (statement of William J. McDonough, President, Federal Reserve Bank of New York), *available at* <http://newyorkfed.org/newsevents/speeches/1998/mcd981001.html>.

⁷⁰ On an interesting side note, of all the banks asked to participate, the only bank that refused to contribute any money was Bear Sterns, and a decade later during the financial crisis Bear was in the same position as LTCM, begging for a private sector bailout. WILLIAM D. COHAN, *HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET* 247–51 (Double Day 2009).

⁷¹ Reade Everett, *Deriving a Solution for Derivative Reform: Proposals to Reconstruct Over-the-Counter Derivative Markets*, 28 REV. BANKING & FIN. L. 479, 483 (2009).

⁷² *Id.*

⁷³ CFTC Concept Release, *Over-the-Counter-Derivatives* (May 7, 1998), *available at* <http://www.cftc.gov/opa/press98/opamntn.htm>. A concept release is a document that invites the public to make comments regarding a proposed rule before the new rule is formally proposed. *Id.*

frequency of large losses among market participants, and the increased diversity of market participants, including less sophisticated individuals.⁷⁴ The concept release indicated that the CFTC was considering regulations that would force OTC derivatives transactions to be cleared, require dealers and intermediaries to register with and report to the CFTC, set capital requirements, require derivative dealers to maintain adequate risk management and internal controls, and set restriction on the sales practices used by dealers.⁷⁵

The concept release elicited a strong response from the Federal Reserve Board, the U.S. Treasury, and the SEC. Alan Greenspan, then Chairman of the Federal Reserve Board, and Robert Rubin, then Treasury Secretary, immediately expressed their opposition to the regulation, believing that it would unduly restrict the market for these “extraordinarily useful” risk management tools, and that the private parties were better equipped to regulate the market than the government.⁷⁶ According to a senior director at the CFTC, Greenspan told Born “that she essentially didn’t know what she was doing and she’d cause a financial crisis” by attempting to regulate this market.⁷⁷ Greenspan and Rubin also convinced the chairman of the SEC at the time, Arthur Levitt, to oppose the regulation. Levitt later remembered that “[Greenspan and Rubin] were certainly very fiercely opposed to [regulating the OTC derivatives market] and persuaded me that this would cause chaos.”⁷⁸

In late 1998, Congress reacted to the lobbying efforts of Greenspan, Rubin and Levitt by instituting a freeze on any regulation by the CFTC in the area of OTC derivatives.⁷⁹ The freeze was for a period of six months while the President’s Working Group on Financial Markets⁸⁰ examined whether regulation of the market was necessary.⁸¹ Soon after the temporary freeze was implemented, Born resigned.⁸² In November 1999, the Working Group issued a report on the OTC market and the Commodity Exchange Act that strongly advocated that the CFTC should not have regulatory

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ Peter S. Goodman, *The Reckoning—Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, at A1.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ David Barboza & Jeff Gerth, *Who’s in Charge? Agency Infighting and Regulatory Uncertainty*, N.Y. TIMES, Dec. 15, 1998, at C14.

⁸⁰ The Working Group on Financial Markets is a group of the Executive Branch’s most prominent financial market regulators including the Chairman of the Board of Governors of the Federal Reserve System, Secretary of the Department of the Treasury, and the Chairmen of the SEC and CFTC.

⁸¹ Barboza & Gerth, *supra* note 79.

⁸² Goodman, *supra* note 76.

jurisdiction over the OTC derivatives market.⁸³ The report concluded that “the trading of financial derivatives by eligible swap participants⁸⁴ should be excluded from the [Commodity Exchange Act]” and, therefore, exempted from CFTC’s regulatory jurisdiction.⁸⁵ The Working Group stated that if the CFTC were able to regulate OTC derivatives it “would perpetuate legal uncertainty or impose unnecessary regulatory burdens and constraints upon the development of these markets in the United States.”⁸⁶

Congress responded to the Working Group’s report by enacting the Commodity Futures Modernization Act of 2000 (“CFMA”).⁸⁷ The CFMA “explicitly exempted OTC derivatives from regulation by the CFTC and limited their regulation by the SEC.”⁸⁸ Although federal regulation of OTC derivatives was limited prior to Dodd-Frank, they were and still are subject to private legal rules that are established by the contracts the parties enter into. The International Swaps and Derivatives Association, Inc. (“ISDA”) provides a standard form agreement called the “ISDA Master Agreement” that most market participants use for their OTC derivatives transactions.⁸⁹ This contract is entered into before completing the derivative transaction and sets out the parties’ obligations and establishes the events that will constitute a default and termination of the agreement.⁹⁰ After the parties have signed a Master Agreement, they will enter into a verbal agreement that establishes the terms of the transaction.⁹¹ Following this verbal agreement, they will sign a written confirmation that sets out the terms in writing.⁹² The Master Agreement and the written confirmation together are

⁸³ PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 1 (1999), available at <http://www.treasury.gov/resource-center/fin-mkts/Documents/otcact.pdf>.

⁸⁴ *Id.* at 1 n.4 (“[E]ligible swap participants’ are defined to include various regulated financial institutions, business enterprises that meet certain tests relating to total assets or net worth, certain pension funds, state and local governments, and certain wealth individuals”).

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ THE DEPT. OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 46–48 (2008), available at <http://www.mofo.com/files/Uploads/Images/200803-Treasury-Report.pdf>.

⁸⁸ Frank D’Souza, Nan Ellis & Lisa Fairchild, *Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market*, 12 U. PA. J. BUS. L. 473, 493 (2010).

⁸⁹ Frank Partnoy, *ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 213, 217 (2002).

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* at 217–18.

the basis for the private rules that typically governs OTC derivatives transactions.⁹³

III. REGULATION OF THE OVER-THE-COUNTER DERIVATIVE MARKET UNDER DODD-FRANK

Dodd-Frank imposes a broad array of new restrictions and regulations that will reshape the derivatives market. Congress has delegated this important task to the SEC and the CFTC, and both agencies will have a large amount of discretion in implementing and shaping this statute.⁹⁴ The purpose of this section is not to parse every line of Dodd-Frank, but rather focus on the most controversial and consequential provisions. To this end, the regulations regarding derivatives trading at banks, capital and margin, clearing, and exchange trading will be examined.

A. *Derivative Trading at Banks*

1. *Summary of the Derivative Trading Activities at Banks*

The U.S. banking industry is by far the dominant player in the global OTC derivatives market with U.S. commercial banks holding approximately \$223 trillion of the \$582 trillion outstanding notional amount as of the second quarter of 2010.⁹⁵ The U.S. banking industry, in turn, is

⁹³ *Id.*

⁹⁴ The agencies will have authority over different types of OTC derivatives, with the CFTC having authority over an instrument if it is defined as “swap,” while the SEC will have authority if the instrument is defined as a “security based swap.” If the instrument has qualities of both a “swap” and a “security based swap,” it will be defined as a “mixed swap,” and the CFTC and SEC will share regulatory jurisdiction. The definition of “swap” under the Dodd-Frank Act includes most types of options, forwards, and instruments traditionally referred to as swaps being traded in the OTC market with some limited exceptions, while a “security based swap” is simply any instrument defined as a “swap” that is based on a single security, “narrow-based” (generally means less than ten component securities) securities index, or occurrence of some event relating to the issuer of a security or issuers of a “narrow based” securities index (i.e., CDSs). Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 712, 721, 761, 124 Stat. 1641, 1658, 1754 (2010).

⁹⁵ OCC, QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES: SECOND QUARTER 2010 1, available at <http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq210.pdf>; *Amounts outstanding of over-the-counter (OTC) derivatives by risk category and instrument: Publication up to 2010 Q2* BANK FOR INT’L SETTLEMENTS 1, <http://www.bis.org/statistics/derstats.htm> (last visited Mar. 29, 2011).

dominated by only a few banks, with ninety-six percent of the total national amount being held by only five of the largest dealer-banks.⁹⁶

In the derivatives market, banks act as hedgers, dealers and speculators.⁹⁷ Approximately seventy-seven percent of the U.S. banks that hold derivatives utilize them “solely for hedging purposes,”⁹⁸ but the vast majority of the notional value of derivatives at U.S. banks is held by banks not as hedgers—i.e., “end users”—but as dealers.⁹⁹ Dealing is more risky than hedging and can also contain an element of speculation masked as dealing.¹⁰⁰

When banks are acting as derivative-dealers for customers, they do so in one of three ways. First, the bank can engage in matched trading, where “a dealer enters into a trade with a customer and then enters into an equal, offsetting position with another counterparty.”¹⁰¹ In matched trading, the dealer’s profit is the spread, which is the difference between the price at which the dealer sells the derivatives position to one party and what the dealer pays for an equal but opposite position from another party.¹⁰²

The second type of derivatives dealing is market-making. This is similar to matched trading except the bank does not have an offsetting trade immediately available, but by the end of the trading day, the bank has found other avenues to offset most of its risk exposures.¹⁰³ This does, however, expose the banks to the risk of adverse market changes during the day. To offset this risk, the bank will charge a higher fee— similar to an insurance company raising its premium on riskier policies—to compensate the bank for the increased risk.¹⁰⁴

The final type of dealer activity is called positioning. In positioning, the bank fills an order for a customer, but does not purchase an offsetting position.¹⁰⁵ Though there are a number of legitimate reasons for positioning, this practice can also operate as an insidious way for the bank to engage in speculation.¹⁰⁶ If, for example, the bank believes that the market will turn against a customer’s position, it may not want to offset the

⁹⁶ OCC, *supra* note 95, at 1.

⁹⁷ FDIC, *supra* note 41.

⁹⁸ *Id.*

⁹⁹ See OCC, *supra* note 95, at graph 1.

¹⁰⁰ *Derivatives Risk in Commercial Banking*, *supra* note 41.

¹⁰¹ *Id.*

¹⁰² For example, if the bank sells a CDS insuring a \$1 million bond for \$50,000 to party X and then purchases a CDS insuring that same \$1 million bond from party Y for \$49,000, the bank has made \$1000.

¹⁰³ *Derivatives Risk in Commercial Banking*, *supra* note 41.

¹⁰⁴ See *id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

trade so that it can reap the profits from the market movements it expects; however, the bank will also be exposed to all the downside risk as well. When banks engage in speculation by not offsetting customer trades it is called “embedded proprietary trading” and can be difficult to distinguish from legitimate dealer activities.¹⁰⁷

Speculative trading is by far the most risky derivatives activity a bank may engage in due to the bank’s exposure to a large amount of market risk.¹⁰⁸ Though speculative trading is closely associated with proprietary trading, which is when the bank trades on its own account rather than that of a client, speculative trading can take place even in a “customer driven” transaction when the bank engages in “embedded proprietary trading,” which was mentioned above.¹⁰⁹ The extent to which banks are actually engaging in speculative trading is difficult to determine and is seldom reported.

2. Regulation Under the Dodd-Frank Act

Banks’ trading derivatives are regulated in two ways under Dodd-Frank: the “Volcker Rule” and the “push-out provision.” The “Volcker rule”—proposed by Paul Volcker, former Chairman of the Federal Reserve—would prevent a “banking entity” from engaging in proprietary trading in, inter alia, any type of derivative.¹¹⁰ The definition of proprietary trading under the statute would prohibit the bank from “engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell or otherwise dispose of [any type of derivative].”¹¹¹

However, because there can be a number of legitimate—i.e., non-speculative—ends met by certain types of proprietary trading, legislators inserted a number of exceptions from this ban. The exemptions would continue to allow banks to engage in “proprietary trading” so long as it is “in connection with . . . market making related activities, to the extent that any such activity . . . are designed not to exceed the reasonably expected

¹⁰⁷ *Dropping Swaps Plan for Volcker Rule May Not Reduce Bank Risk*, BLOOMBERG BUSINESSWEEK (June 11, 2010, 1:00 PM), <http://news.businessweek.com/article.asp?documentKey=1377-aVvPZYInzAx0-600TTI0BCNQE4G82RR8A2OA37A> [hereinafter *Dropping Swaps Plan*].

¹⁰⁸ *Derivatives Risk in Commercial Banking*, *supra* note 41.

¹⁰⁹ Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the “Business of Banking”*, 63 U. MIAMI L. REV. 1041, 1097 (2009).

¹¹⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1620 (2010); *Dropping Swaps Plan*, *supra* note 107.

¹¹¹ Alison Vekshin & Phil Mattingly, *Lawmakers Reach Compromise on Financial Regulation*, BLOOMBERG (June 26, 2010, 12:01 AM) <http://www.bloomberg.com/news/2010-06-25/lawmakers-reach-compromise-on-financial-regulation.html>.

near-term demands of clients, customers, or counterparties.”¹¹² Banks will also be able to engage in “proprietary trading” if it is for hedging purposes or on behalf of a customer.¹¹³ The statute is defined in such a way as to prohibit only proprietary trading of a speculative nature.

There are, however, a number of academics and politicians that believe the Volcker Rule is insufficient to mitigate the risks derivatives pose to the banking industry.¹¹⁴ They propose that commercial banks should be forced to create separate companies to perform derivatives trading.¹¹⁵ In response, former Senator Blanche Lincoln, Democrat of Arkansas, introduced what became known as the “push-out provision,” which forces banks to spin off their derivative trading desks into separately capitalized affiliates.¹¹⁶

The “push-out provision,” which is contained in the section titled “Prohibition Against Federal Government Bailouts of Swaps Entities,” states that “no Federal assistance may be provided to any swap entity with respect to any swap, security-based swap, or other activity of the swaps entity.”¹¹⁷ Dealer banks that will likely be considered “swap dealers” under the statute will, as a result of their classification as “swap dealers,” fall under the definition of “swaps entity.”¹¹⁸ The definition of “federal assistance” includes FDIC insurance and access to the different lending facilities provided by the Federal Reserve, including the discount window and many, but not all, of the other credit facilities it offers.¹¹⁹ Because access to FDIC insurance is required by law for many banks and is “virtually a necessity” for the few banks not required to possess it, this provision effectively prohibits covered banks from engaging in “proprietary trading” as defined by Dodd-Frank.¹²⁰

¹¹² Dodd-Frank Wall Street Reform and Consumer Protection Act §619.

¹¹³ *Id.*

¹¹⁴ See, e.g., Jane D’Arista & Gerald Epstein, *Banks Must Be Barred from Dealing Derivatives: It’s Not a Normal Part of the Business of Banking*, HUFFINGTON POST, May 10, 2010, http://www.huffingtonpost.com/safer/banks-must-be-barred-from_b_569824.html.

¹¹⁵ *Id.*

¹¹⁶ *Id.*; Dodd-Frank Wall Street Reform and Consumer Protection Act §716.

¹¹⁷ Dodd-Frank Wall Street Reform and Consumer Protection Act §716.

¹¹⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 716, 721.

¹¹⁹ The definition of “federal assistance” still allows the Federal Reserve to provide emergency lending to swaps entities under the Federal Reserve Act because it only prohibits assistance from the Fed “that is not part of a program or facility with broad-based eligibility under 13(3)(A) of the Federal Reserve Act.” Dodd-Frank Wall Street Reform and Consumer Protection Act § 716.

¹²⁰ Michael P. Malloy, *Can 10b-5 for the Banks? The Effect of an Antifraud Rule on the Regulation of Banks*, 61 FORDHAM L. REV. S23, S41 n.111 (1993).

The initial language of the bill was widely criticized because it would prevent banks from hedging¹²¹ and acting as dealers¹²² with the result that banks would be restricted in their ability to manage risk, distorting the market for derivatives, and even possibly driving many derivatives trades into the “dark corner” of the market.¹²³ In response to these criticisms, the final version of Dodd-Frank unambiguously allow banks to use derivatives for hedging and will allow banks to deal in certain types of derivatives, including those whose underlying “rates or reference assets that are permissible for investment by a national bank” and CDS’s on corporate bonds, but only if the institution has high credit ratings and the CDS is cleared.¹²⁴ The effect of this watered down version is expected to be minimal as “\$500 trillion of the \$615 trillion OTC derivative market will now be exempt from the prohibition, but it will force out the derivative that has been largely perceived as one of the riskiest: CDS’s on low quality debt instruments.”¹²⁵ The new language also resolves some prior ambiguity by allowing a bank to keep the riskier derivatives activities at subsidiaries within the holding company so long as the subsidiary’s capital is separate from the bank.¹²⁶

3. Criticism of Dodd-Frank

The primary goal of Dodd-Frank should be to reduce the market risk that banks are able to take. The reason that market risk, rather than other

¹²¹ Letter from Ben Bernanke, Chairman of the Federal Reserve, to Senator Christopher Dodd, Chairman of the Committee on Banking, Housing, and Urban Affairs (May 12, 2010) (“Prohibiting depository institutions from engaging in significant swaps activities will weaken the risk mitigation efforts of banks” and that “[f]orcing these activities out of insured depository institutions would weaken . . . financial stability.”).

¹²² *Id.* (“[Banks play] an essential role [in] providing market-making functions for these products.”).

¹²³ Ben Bernanke argued that if the provision forces all swaps activities out of banks, the demand will be met by institutions that are not as well regulated and capitalized as banks and industry analysts estimated that \$294 trillion worth of derivatives would be driven “beyond the reach of regulators” as the result of an overbroad “push out” provision. *Id.*; Brady Dennis, *Derivatives-Spinoff Proposal Opposed as Part of Overhaul Bill*, WASH. POST, May 4, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/05/03/AR2010050304094.html>.

¹²⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716(d).

¹²⁵ *Id.* § 716 (d)(2), (d)(3); Robin Maxwell & Rebecca Wasserman, *Derivatives Reform: Bank Push-Outs Under Dodd-Frank*, WESTLAW BUS. (Aug. 5, 2010), http://currents.westlawbusiness.com/Articles/2010/08/20100805_0012.aspx?src=RSS.

¹²⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act § 716(c).

types of risk, should be its primary goal is that the other risks need to be reduced across the entire industry and are, therefore, better addressed by industry wide legislation. Allowing certain institutions to take on significant market risk via speculative trades is important to the health of the derivatives market because speculators are a key source of liquidity; however, preventing banks from taking on excessive market risk is important to protect taxpayer funds that are at risk via Federal Reserve lending and FDIC insurance that, in effect, would subsidize banks in their quest for the higher returns that accompany high market risk trades.¹²⁷ The way in which both the “Volcker Rule” and the “push-out provision” are tailored to primarily restrict only speculation while allowing dealing and hedging is prudent because the market risk of dealing and hedging is largely negated through offsetting positions.¹²⁸

While the Dodd-Frank is successful in many ways, there are a number of areas in which the Act needs to be amended. First, it is important that Dodd-Frank deals with the possibility of “embedded proprietary trading.” It appears that Dodd-Frank allows this type of trading activity so long as it was customer originated—thereby complying with the “Volcker Rule”—and in one of the derivatives allowed under the “push-out provision.” This omission may not be much of a concern, given that bank regulators have broad authority to compel banks to keep risk to a minimum; however, as the agencies issue rules to carry out Dodd-Frank, they should be aware of this insidious form of speculative trading and deal with it accordingly. The second concern is with the “push-out provision.” The concern is that it is simply unnecessary.¹²⁹ By pushing out certain derivatives, legislators believe that they are reducing the market risks posed by the positions, but if there are offsetting positions, the market risks posed by these transactions can be negated.¹³⁰

B. *Capital and Margin Requirements*

1. *The mechanics of capital and margin requirements*

The provisions of Dodd-Frank that require an entity to post minimum levels of capital and margin for most derivatives transactions are some of the most beneficial provisions of the new Act. By requiring minimum levels of capital and margin, the provision will limit the counterparty risk an entity poses to its counterparties by ensuring the entity has sufficient

¹²⁷ Krawiec, *supra* note 27, at 15.

¹²⁸ See *supra* Pt.III.A.1.

¹²⁹ See, e.g., Edward Wyatt, *In Tough Stance on Wall St., Democrat Finds Few Allies*, N.Y. TIMES, May 16, 2010, at A16.

¹³⁰ See *Derivatives Risk in Commercial Banking*, *supra* note 41 and accompanying text.

funds to meet its obligations. For an entity to meet its capital requirements it will have to set aside a certain amount of capital for each derivative it enters.¹³¹ Margin requirements are comparable to capital requirements in most ways. The amount of margin that must be posted for a given derivative transaction is comparable to the amount of capital that would be required,¹³² and it imposes the same costs by tying up funds that could otherwise be used for investment. Margin requirements differ from capital requirements slightly in the way in which they function. First, unlike capital requirements, the funds posted to meet the margin requirements typically do not stay on the entity's books but rather are deposited directly with the counterparty.¹³³ Second, margin requirements mandate that both initial and variation margin be posted.¹³⁴ Initial margin is very similar to capital requirements in that it requires a certain amount of funds—generally a percentage of the notional value of the swap—be posted in order to provide some buffer against losses in case the depositing counterparty were to default.¹³⁵ Variation margin differs slightly because it requires that the counterparties mark-to-market the value of the swap on a daily basis and that the losing counterparty exchange an amount equal to the difference between the previous day's close and the current day's close.¹³⁶ The purpose of variation margin is to limit counterparty risk by ensuring that credit exposure remains constant through the life of the derivative.¹³⁷

¹³¹ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 731, 764.

¹³² "COMPARABILITY—The entities described in clause (i) shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements and minimum initial and variation margin requirements, including the use of non-cash collateral, for—(I) swap dealers; and (II) major swap participants." Dodd-Frank Wall Street Reform and Consumer Protection Act § 731(e).

¹³³ *Id.* §§ 724, 763.

¹³⁴ *Id.* §§ 731, 764.

¹³⁵ See Anupam Chander & Randall Costa, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 647–48 (2010).

¹³⁶ *Id.*

¹³⁷ An example of how variation margin keeps credit risk constant follows: if the market value of a credit default swap on \$1 million in bonds transaction increases to 300 basis points (market value of swap is \$30,000) from the previous day's price of 250 basis points (market value of \$25,000) to reflect the increased likelihood that the corporate bonds will go into default, then the variation margin to be paid from the issuer to the purchaser is fifty basis points (\$5000). The payment allows the purchaser's initial credit risk exposure (\$25,000) to remain constant because even though purchaser would now have to pay \$30,000 in the market for a new credit default swap if the issuer defaulted, the original purchaser has received \$5000 which offset the increased risk. *Id.*

2. Regulation Under Dodd-Frank

Dodd-Frank imposes capital and margin requirements on derivative trades by either requiring that the trade be cleared by a specified clearing organization, which will impose their own margin requirements on the counterparty,¹³⁸ or by requiring that certain entities post capital and margin for their uncleared trades.¹³⁹ Though Dodd-Frank breaks margin and capital requirements into two different categories—those for “swaps” and those for “security-based swaps”—the effect of the statute is similar regardless of the classification.¹⁴⁰ The classification simply determines regulatory jurisdiction with the CFTC primarily regulating the former and the SEC the latter.¹⁴¹ Further, the regulators responsible for setting the requirements are required to have comparable requirements so a firm’s level of capital and margin will not vary widely between regulators.¹⁴² Because the language of the two sections is nearly identical, this paper will only address the language relating to “swaps” and address “security-based swaps” only if there is a notable divergence.

Dodd-Frank mandates that the capital levels must be set at levels that will “help ensure the safety and soundness” of the entity and that are “appropriate for the risk associated” with the derivative.¹⁴³ Capital and margin requirements for uncleared swaps will also be higher than for cleared trades to “offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared”¹⁴⁴ Further, when setting capital requirements, regulators will take into account the risks posed by other activities at the institution.¹⁴⁵

Dodd-Frank requires regulators to impose capital and margin requirements upon all uncleared derivatives of any firm that is classified as either a “major swap participant” or a “swap dealer.”¹⁴⁶ The definition of a “major swap participant” is “any person who is not a swap dealer,” and has a “substantial position” in derivatives taking into account certain

¹³⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act § 725(c).

¹³⁹ *See id.* §§ 731, 764.

¹⁴⁰ Though the statute only refers to “swaps” and “security-based swaps,” these definitions encompass most OTC derivative products, including forwards and options, and are not limited to those products traditionally referred to as swaps. *See* PRESIDENT’S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 83.

¹⁴¹ It is important to note that if there is a bank involved, it will be that entity’s prudential regulator that will be the primary determinant of the bank’s capital and margin requirements. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 731, 764.

¹⁴² *Id.* § 731(e).

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* §§ 731(d), 764(e).

¹⁴⁶ *Id.* § 731(e).

exemptions, has significant counterparty risk, or is highly leveraged and has a substantial position with no allowance for any exemptions.¹⁴⁷ Because the definition of “substantial position” is to be defined by the relevant Commission, the exact scope of this provision will largely fall to the regulators.¹⁴⁸

A “swap dealer” is any person who “holds itself out as a dealer in swaps; makes a market in swaps; regularly enters into swaps with counterparties as an ordinary course of business for its own account; or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.”¹⁴⁹ This definition will certainly include the largest dealer banks, but also some of the other smaller banks which deal in derivatives. There is, however, an exemption for banks that only provide derivatives to customers when in conjunction with a traditional loan.¹⁵⁰

During the drafting of the bill, there was widespread criticism of these definitions because it was feared that end-users would be subject to clearing and margin requirements. The International Swaps and Derivatives Association has conducted research and believes that if end-users are subjected to these requirements and if the requirements are imposed on existing contracts, it could cost “as much as \$1 trillion in capital and liquidity requirements.”¹⁵¹ The primary fear was that end-users would fall within the definition of “major swap participant” or that their swaps will have to be cleared and, ergo, be subject to the derivative clearing organization’s (“DCO”) requirements. Legislators have responded to this concern both by specifically exempting end-users from the clearing requirement¹⁵² and, although there is no specific exemption for end-users from the definition of “major swap participant,” there is legislative history that will remove end-users from this requirement.

One piece of this legislative history is a letter from two of the primary authors of the Senate bill, former Senator Dodd and former Senator Lincoln, to their House of Representative counterparts stating that “margin and capital requirements are not to be imposed on end-users” and that the requirements should “not punish those who are trying to hedge their own

¹⁴⁷ *Id.* § 721(33).

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* § 721(49).

¹⁵⁰ *Id.*

¹⁵¹ Press Release, Int’l Swaps & Derivatives Assoc., U.S. Companies May Face US \$1 Trillion in Additional Capital and Liquidity Requirements As a Result of Financial Regulatory Reform, According to ISDA Research (June 29, 2010), available at <http://www.isda.org/media/press/2010/press062910.html>.

¹⁵² Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723, 763.

commercial risk.”¹⁵³ The primary authors of the bill in the House of Representatives have also expressed similar opinions. During colloquy on the House floor between Representative Colin Peterson and Barney Frank, Representative Peterson stated that any characterization of the bill as subjecting end-users to capital and margin requirements was “patently false” and that “nowhere in this section do we give regulators any authority to impose capital and margin requirements on end-users.”¹⁵⁴ Representative Frank agreed with Representative Peterson’s statement.¹⁵⁵ Because there is sufficient legislative history to indicate Congress did not intend to regulate end-users in this way, if a regulatory agency were to attempt to impose these requirements on an end-user, the end-user would likely be able to successfully challenge it in court.¹⁵⁶

Congress has also responded to the concern that the end-users’ dealers would simply pass on the costs of these new requirements to their end-user customers, thereby indirectly subjecting end-users to the burdens of this requirement by drafting the legislation so that the margin and capital requirements on transactions between dealer and end-user are “consistent with the congressional intent to protect end-users from burdensome costs.”¹⁵⁷ Although this compromise may not completely eliminate the issue, it will help manage the cost of derivatives for hedgers by leading regulators to impose less onerous requirements on transactions in which a counterparty is an end-user.

3. *Criticism of Dodd-Frank*

While the efficacy of the section will largely depend on the capital or margin requirements set by the regulators, there is one major problem with the statute itself that needs to be remedied. The problem is that Dodd-Frank will not subject existing derivatives to any form of capital or margin requirements because they are explicitly exempted from the clearing requirements,¹⁵⁸ and though not stated in the statute explicitly, legislators have stated that they did not intend capital and margin requirements to

¹⁵³ Letter from Senator Blanche Lincoln & Senator Christopher Dodd to Congressman Barney Frank & Congressman Colin Peterson (June 30, 2010), available at <http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf>.

¹⁵⁴ 156 CONG. REC. H5245 (June 30, 2010) (statement of Rep. Peterson).

¹⁵⁵ *Id.* at H5248.

¹⁵⁶ End-users would likely be able to successfully challenge the regulation because Congressional intent is clear and the agencies tasked with enforcing the legislation “must give effect to the unambiguously expressed intent of congress” when doing so. *Chevron v. Natural Resources Defense Council*, 467 U.S. 837, 842–43 (1984).

¹⁵⁷ Letter from Lincoln and Dodd, *supra* note 153.

¹⁵⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723(a), 763(f) 124 Stat. 1675 (2010).

apply existing contracts. Senator Chris Dodd and Senator Blanche Lincoln wrote that:

Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated, modified, amended, or supplemented based . . . on the implementation of any requirement in the Act¹⁵⁹

Given the significant amount of outstanding OTC derivatives, this omission has the effect of, at least temporarily, severely circumscribing the effect of the law. Though forcing capital or margin requirements on existing swaps would impose an unforeseen burden on market participants, failure to do so would be a mistake. If this exemption is permitted, it could allow entities to continue to pose significant counterparty risk, which puts its counterparties and the entire economy at risk.

C. *Clearing Requirements*

1. *The Mechanics of Clearing Requirements*

Clearing requirements for derivatives are an important tool in limiting the counterparty risk that market participants are exposed to. The way in which clearing works is relatively simple. After two counterparties have decided to enter into a derivative, they will approach a clearing organization that will buy the derivative from the seller and then immediately turn around and sell an identical derivative to the buyer.¹⁶⁰ Because there are two different derivatives, one between the buyer and the clearinghouse and the other between the seller and the clearinghouse, the counterparty risk between the buying and selling counterparty is eliminated and assumed by the clearing organization.¹⁶¹ Although clearing organizations are not subject to significant levels of market risk due to the fact they are entering into offsetting positions,¹⁶² because the clearing organization takes the role of both purchaser and seller, they are, however, exposed to significant levels of counterparty risk.

The primary benefit of clearing is that the clearing organization, by assuming the counterparty risk of the derivative, insulates non-defaulting

¹⁵⁹ Letter from Dodd and Lincoln, *supra* note 153.

¹⁶⁰ Chander & Costa, *supra* note 135, at 651.

¹⁶¹ *Id.*

¹⁶² *Id.* at 652.

counterparties from the losses associated with a default.¹⁶³ In the event of a default, the clearing organization is also better able to absorb the losses by distributing the loss among its members by drawing from the “default mutualization fund” that all members are required to contribute to.¹⁶⁴

2. Clearing Requirement Under Dodd-Frank

Like the capital and margin requirements, the clearing requirements are split into both “swaps” and “security-based swaps.” Dodd-Frank requires derivative must be submitted to either a DCO if it qualifies as a “swap” or a clearing agency if it is a “security-based swap” unless some exemption applies.¹⁶⁵ For a clearing organization to be willing and able to accept a derivative for clearing, it must both meet the internal eligibility requirements of the organization and also be deemed suitable for clearing by the relevant Commission.¹⁶⁶ For the clearing organization to be willing to clear a certain type of derivative, it must be standardized so as to facilitate the efficient processing of trades and liquid in order to manage the risk associated with it.¹⁶⁷ To ensure that clearing organizations only clears appropriate trades they must submit a request to and be granted permission from the relevant Commission before it is able to clear a certain type of derivative.¹⁶⁸

There is also an exemption for end-users. It exempts derivatives in which one of the counterparties “(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into non-cleared swaps.”¹⁶⁹ The party that qualifies for the end-user exemption may still request that the swap be cleared, but this is left up to its discretion.¹⁷⁰

In order to ensure their safe and sound operation, clearing organizations must be registered with either the SEC or the CFTC or fall into one of the narrow exemptions from registration.¹⁷¹ In order for a derivative clearing organization to be in compliance—i.e., “to be registered and to maintain

¹⁶³ *Id.*

¹⁶⁴ *Id.* at 653–54.

¹⁶⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723, 763, 124 Stat. 1675, 1762 (2010).

¹⁶⁶ *Id.*

¹⁶⁷ Erika W. Nijenhuis et al., *Credit Default Swaps in the New Regulatory Environment*, 906 PLI/TAX 59, 63 (2010).

¹⁶⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723, 763.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ *Id.* §§ 725, 763.

registration”—it must observe a number of rules and regulations imposed on them both by the statutes and by the relevant Commission.¹⁷² The regulations of the clearing organizations that clear “swaps” and those that clear “security-based swaps” are slightly different. DCOs must comply with “core principles” set out in the statute and comply with CFTC mandates,¹⁷³ while clearing agencies must comply with the rules set forth by the SEC, which will “reflect evolving United States and international standards.”¹⁷⁴

3. *Optimal clearing requirements*

The clearing requirement provision was one of the least contentious provisions and many of the concerns that were initially raised have been addressed. One concern addressed in the statute is the safe operation of these organizations, as they are susceptible to failure just as any other derivative counterparty.¹⁷⁵ The best way to ensure that clearing organizations operate safely is for the relevant agencies to ensure that they comply with the “core principles” that DCOs, but not clearing agencies, must already comply with.

The first principle is that the organization “shall have adequate financial, operational, and managerial resources . . . to discharge” its responsibilities.¹⁷⁶ While the bill does not specify what would constitute adequate operational or managerial resources, it does establish a base level of financial resources that must be present. The derivative clearing organization must maintain a level of financial resources, including adequate capital reserves, that would allow it to continue to meet its obligations to its counterparties “notwithstanding a default by [the counterparty] creating the largest financial exposure for that organization in extreme but plausible market conditions” and also meet its operational expenses for one year.¹⁷⁷

Second, the clearing organization must set and maintain certain eligibility requirements for those wishing to clear their derivatives and the products to be cleared.¹⁷⁸ The derivative clearing organization must set admission standards for clients that take into account the “financial resources and operational capacity to meet obligations from participation in

¹⁷² *Id.*

¹⁷³ *Id.* § 725.

¹⁷⁴ *Id.* § 763.

¹⁷⁵ See, e.g., Gillian Tett, *Insight: The Clearing House Rules*, FIN. TIMES, Nov. 5, 2009, <http://www.ft.com/cms/s/0/5874e922-ca1d-11de-a5b5-00144feabdc0.html#axzz1Hj6n0lkb>.

¹⁷⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act § 725.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

the derivatives clearing organization,” which means the clearing organization must be relatively confident the client will not default on its obligations.¹⁷⁹

Third, the DCO is required to have adequate risk management tools in place to manage the substantial amount of counterparty risk that it will undertake.¹⁸⁰ Dodd-Frank requires that these clearing organizations constantly monitor their risk exposure for each client on a daily basis and implement the required measures to ensure that even if some clients do default “the operations of the [DCO] would not be disrupted; and non-defaulting members or participants would not be exposed to losses that non-defaulting members or participants cannot anticipate or control.”¹⁸¹ To this end, the bill mandates that the DCO set margin requirements¹⁸² for their customers that “shall be sufficient to cover potential exposures in normal market conditions.”¹⁸³

These three provisions together help ensure that the clearing organization itself will not default on its obligations to counterparties by ensuring it has procedures in place to lessen the chance and effect of client defaults and also have sufficient funds available to cover any possible losses. Given the possibly catastrophic effect of the default of a clearing organization, it is imperative that these three core principles be implemented to the fullest possible extent.

D. Exchange Trading

1. *The Mechanics of Exchange Requirements*

Dodd-Frank proposes that a number of OTC derivatives be traded on organized exchanges. The benefit of forcing cleared swaps onto exchanges is that the exchanges will aid in the price discovery of these instruments by providing “continuous data on prices of transactions” and also increase the liquidity in the market.¹⁸⁴ The primary benefit from trading derivatives on exchanges is that it will reduce the bid-ask spreads on many swaps.¹⁸⁵ The

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² It is almost certain the DCO will require both variation and initial margin, but that was not explicitly addressed in the bill. See Chander & Costa, *supra* note 135, at 653.

¹⁸³ Dodd-Frank Wall Street Reform and Consumer Protection Act § 725.

¹⁸⁴ Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL’Y 671, 703–04 (2010).

¹⁸⁵ SQUAM LAKE WORKING GROUP ON FIN. REGULATION, COUNCIL ON FOREIGN RELATIONS: CENTER FOR GEOECONOMIC STUDIES, CREDIT DEFAULT SWAPS, CLEARINGHOUSES, AND EXCHANGES 5 (2009).

bid-ask spread represents what market makers will pay and the price at which they are willing sell at a given point in time with the former almost always lower than the latter.¹⁸⁶ Because “the spread between the ask and the bid represents a transaction cost for the investors,” by lowering this spread, exchange trading will reduce the operating costs of those in the derivatives market and promote their use by end users.¹⁸⁷ The increased price transparency will also benefit market participants because timely and accurate prices are important variables when setting margin requirements so as to manage counterparty risk.¹⁸⁸ Liquidity will also benefit market participants by allowing them to quickly close out a losing position in order to mitigate losses.¹⁸⁹

2. Exchange Trading Requirements under Dodd-Frank

The bill requires that derivatives subject to the clearing requirement be executed “on a board of trade designated as a contract market” or “on a swap execution facility,” but only if there is a “market” or “facility” willing to accept it.¹⁹⁰ This requirement will not apply if one of the parties to the transaction qualifies for the end-user exemption from clearing.¹⁹¹ A swap “board of trade” is simply a facility where multiple buyers and sellers come together to execute and trade swaps, but to be designated as a “contract market,” the “board of trade” must comply with all the “core principles” set out in the statute and regulations imposed by the Commissions.¹⁹² A swap execution facility (“SEF”) is similar to a “board of trade” and is defined as a “trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system . . . including any trading facility, that (A) facilitates the execution of swaps between persons; and (B) is not a designated contract market.”¹⁹³ The SEFs must either be registered under the act or fall under an exemption from registration.¹⁹⁴ For the SEF to be registered it must “comply with (A) the core principles described in this

¹⁸⁶ The spread effectively represents the premium buyers and sellers are willing to pay to either purchase or sell the swap *immediately*. If for example, a buyer needed to buy a swap immediately he would have to pay the ask price but if he was not time constrained or concerned that the price might rise further he could just offer the lower bid price and hope someone lowers their asking price to meet it.

¹⁸⁷ SEC, *Division of Enforcement: Recent Cases and Issues*, 978 PLI/CORP 7, 185 (1997).

¹⁸⁸ Scott, *supra* note 184, at 703.

¹⁸⁹ *Id.* at 704.

¹⁹⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723, 763, 124 Stat. 1675, 1762 (2010).

¹⁹¹ *Id.*

¹⁹² *Id.* § 735.

¹⁹³ *Id.* § 721(50).

¹⁹⁴ *Id.* § 733.

subsection; and (B) any requirement that the Commission may impose by rule or regulation pursuant to section 8a(5).”¹⁹⁵

The “core principles” that boards of trade must observe to be designated as a contract market and those which SEFs need to comply with in order to be registered are similar. Both have “reasonable discretion” in implementing them subject to the rules and regulations of the relevant Commissions.¹⁹⁶ The core principles dictate that, like stock exchanges such as the New York Stock Exchange, both shall establish and enforce rules for its members, including membership eligibility guidelines, the terms and conditions of the derivatives being traded, the process by which the swaps will be traded, and abuse detection and prevention tools.¹⁹⁷ Both must also collect and make public information surrounding the swaps that are being traded on the facility.¹⁹⁸ Finally, they must ensure that they have adequate financial, operational, and managerial resources to operate, and they must ensure the “financial integrity of swaps,” including ensuring compliance with the clearing requirements.¹⁹⁹

3. *Optimal Exchange Trading Requirement*

Much like the provision requiring clearing of certain swaps, the exchange requirements have received little criticism. The only concern is that if the SEFs and boards of trade are run by the large dealer banks, the exchanges may purposefully restrict the amount of information they make public in the hopes that the price opacity will allow the dealer banks to charge a larger bid-ask spread.²⁰⁰ Though the SEFs are required to “make public timely information on price, trading volume, and other trading data on swaps” and boards of trade are required to make similar information public on a daily basis, if dealer banks obtain significant influence on exchanges, they could pressure the exchanges to only minimally comply with these mandates.²⁰¹

To address this concern, Dodd-Frank requires that the Commissions adopt rules with the intended purpose of reducing any conflict of interest between the exchanges and swap dealers and major swap participants.²⁰² The statute specifically mentions that the commissions may mandate “numerical limits on the control of, or the voting rights with respect to”

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* §§ 733, 735.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ Gretchen Morgenson, *3,000 Pages of Financial Reform, but Still Not Enough*, N.Y. TIMES, May 30, 2010, at BU1.

²⁰¹ Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 733, 763.

²⁰² *Id.* §§ 726, 765.

either SEFs or boards of trade.²⁰³ Given the benefits provided by having transparent derivatives exchanges, the Commissions should avoid any pressure to capitulate to large dealer banks.

IV. CONCLUSION

With the enacted of Dodd-Frank, the landscape of the OTC derivatives market has been fundamentally altered. The much-needed regulatory overhaul has left the economy and individual participants less susceptible to the extreme market fluctuations seen in the recent financial crisis, but has also imposed significant new burdens on both private entities. Though Dodd-Frank remedies a number of regulatory oversights that likely exacerbated the recent financial crisis, there are still numerous actions that regulators may take that could increase the stability of the market and decrease costs the regulation imposes. As many of the agency regulations that will shape Dodd-Frank have not yet been implemented, the future efficacy of Dodd-Frank is, in many ways, yet to be seen.

²⁰³ *Id.*

